PRESENT LAW AND ISSUES RELATING TO THE CONSERVATORSHIP OF THE EXECUTIVE LIFE INSURANCE COMPANY

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on MAY 22, 1991

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

MAY 21, 1991

JCX-6-91

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on May 22, 1991, on certain issues related to the conservatorship of the Executive Life Insurance Company. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law provisions and a discussion of related issues.

Part I of this document is a summary. Part II provides background information on the Executive Life Insurance Company conservatorship and discusses factors that may contribute to insurance company insolvency. Part III discusses present law and issues relating to the effects of insurance company insolvency on participants in tax-qualified retirement plans. Part IV discusses issues relating to the effects of insurance company insolvency on nonpension annuitants and beneficiaries of life insurance products. Part V discusses issues relating to Federal guarantees of insurance company products, Federal regulation of insurance companies, and possible alternatives to such approaches.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Issues Relating to the Conservatorship of the Executive Life Insurance Company (JCX-6-91), May 21, 1991.

I. SUMMARY

Background information relating to the insolvency of Executive Life Insurance Company

Executive Life Insurance Company and Executive Life Insurance Company of New York are the two largest subsidiaries of First Executive Corporation, a company based in Los Angeles. Based on gross assets, the life insurance companies owned by First Executive comprise the 15th largest life insurance group in the United States.

On April 11, 1991, the California insurance commission obtained a court-ordered conservatorship of Executive Life in order to provide for the orderly sale of the company and disposition of its assets. Pursuant to court order, the Californian Department of Insurance is authorized to pay 100 percent of the death benefits payable under Executive Life life insurance contracts and 70 percent of the annuities payable under qualified retirement plans.

The State of California has recently established an insolvency guaranty fund that is designed to provide for the indemnification of losses suffered by policyholders of insolvent life insurance companies. It is unclear whether the guaranty fund will cover the policyholders of Executive Life. Even if it does, the coverage provided by the funds is limited so that not all policyholders or investors wil_ be fully covered.

Impact of insurance company insolvency on pension plan participants

Overview of qualified plans

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred.

Qualified plans are broadly classified into two categories, defined contribution plans and defined benefit pension plans, based on the nature of the benefits provided. Under a defined benefit pension plan, benefits are specified under a plan formula. Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each

plan participant.

The qualification standards are generally defined to ensure that qualified plans do not discriminate in favor of highly compensated employees. They also define the rights of plan participants and beneficiaries and place certain limits on the tax deferral possible under qualified plans. In addition, the Code imposes minimum funding standards on defined benefit pension plans that are designed to ensure that such plans have sufficient assets to pay promised benefits.

Pension plan investment in life insurance company products

Qualified pension plan benefits can be affected by insurance company insolvencies in the following cases: (1) annuity contacts are purchased on behalf of plan participants when a defined benefit pension plan terminates, (2) annuity contracts are purchased on behalf of a retiring plan participant from an ongoing defined benefit or defined contribution plan, and (3) guaranteed investment contracts (GICs) are purchased as a plan investment (often an employee-directed investment in a defined contribution plan).

Plan termination insurance program

Under present law, the Pension Benefit Guaranty corporation (PBGC), a Federal corporation within the Department of Labor, provides insurance for certain benefits under defined benefit pension plans in the event the plan is terminated at a time when plan assets are not sufficient to pay plan benefits. The PBGC generally guarantees nonforfeitable retirement benefits up to a certain dollar amount ($2,250 per month for 1991).

To help cover the cost of the guarantee program, premiums are charged with respect to covered defined benefit pension plans. A flat-rate premium of $19 per participant applies to all single-employer defined benefit pension plans. In addition, underfunded plans are required to pay an additional premium of up to $53 per participant based on the amount of underfunding. An individual who has received an irrevocable commitment from an insurance company (i.e., an annuity contract) to pay all the benefits to which the individual is entitled under the plan is not considered a participant for PBGC premium purposes, so that no premiums are assessed with respect to such individuals. In addition, premiums are not required to be paid after a plan has terminated and plan assets have been finally distributed.

A defined benefit pension plan may be voluntarily terminated by the employer or involuntarily terminated by the PBGC. A plan may be terminated by the employer only in a

distress termination or a standard termination. A standard termination is permitted only if the plan has sufficient assets to satisfy all benefit liabilities under the plan. One of the requirements for a standard termination is that plan benefits be provided for through the purchase of annuity contracts or otherwise as permitted by the plan and regulations.

The PBGC currently takes the position that the PBGC guarantee does not apply to annuity contracts that have been distributed pursuant to a plan termination.[2] There is some support in present law both for the position that such contracts are subject to the guarantee and for the position that they are not.

<u>Standards for fiduciaries and insurance companies</u>

The Employee Retirement Income Security Act of 1974 (ERISA) imposes standards of conduct on plan fiduciaries. These rules require, among other things, that a plan fiduciary act solely in the interests of plan participants and beneficiaries. Under present law, the choice of an insurance company to provide annuities for pension plan benefits is subject to ERISA's fiduciary rules.

Federal law does not contain any specific restrictions on standards on the companies that issue pension annuities. However, such companies are subject to extensive State regulation.

<u>Impact of insurance company insolvency on policyholders</u>

The Federal Government does not guarantee or otherwise protect the claims of policyholders or beneficiaries of policies of life insurance companies. This lack of Federal protection occurs at least in part because the regulation of the insurance industry has historically remained with the States. All but three States and the District of Columbia have adopted State guaranty funds that are designed to indemnify policyholders for the losses incurred when an insurance company becomes insolvent. However, most of these funds cap the amount payable to policyholders and may not cover all types of products.

<u>Proper scope of federal guarantee and regulation of insurance companies and products</u>

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[2] The guarantee does not apply to contracts issued to retiring participants before termination because the guarantees do not come into operation until there has been a plan termination.

The possible extension of Federal guarantees to insurance company products benefits raises a number of issues, including (1) the appropriate scope of guarantees of pension benefits, (2) whether the Federal government or the States should provide the guarantees, (3) the pricing of insurance, (4) the problems that result from inadequate pricing, and (5) possible alternatives to an expanded Federal guarantee program.

II. BACKGROUND INFORMATION RELATING TO THE INSOLVENCY OF EXECUTIVE LIFE INSURANCE COMPANY

In general

Executive Life Insurance Company ("Executive Life") and Executive Life Insurance Company of New York ("Executive Life of New York") are the two largest subsidiaries of First Executive Corporation ("First Executive"), a corporation located in Los Angeles. Based on gross assets, the life insurance companies owned by First Executive comprise one of the 15th largest life insurance groups in the United States.

Executive Life owns approximately $10.1 billion in gross assets and has (1) approximately 170,000 life insurance contracts in force with a face value of $38 billion; (2) approximately 75,000 annuities in force with a value of $2.5 billion; and (3) over 300 guaranteed investment contracts (GICs) in force with a value of $3 billion.[3] Executive Life of New York owns approximately $3.2 billion in gross assets and has approximately 103,000 policyholders.[4]

Both Executive Life and Executive Life of New York experienced dramatic growth during the mid-1980's by offering attractive yields on single-premium deferred annuities, GICs, and other insurance products. These companies were able to offer such yields by investing the premiums and other consideration received in high-yield securities generally known as "junk bonds." The assets of First Executive increased from approximately, $800 million in 1980 to approximately $19 billion in 1987.[5]

Due to defaults on several of the high-yield bonds, First Executive reported losses of $776 million in 1989 and $366 million in 1990. In addition, in early April of 1991, First Executive reported that the value of its high-yield bond holdings was $2.6 billion less than the $9 billion value shown on its financial statements for the 1990 year.[6] The high-yield bond holdings account for over one-half of the $16 billion of assets held by First Executive.[7]

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[3] Statement of John Garamendi, California Insurance Commissioner, before the Senate Committee on Commerce, Science, and Transportation (May 7, 1991).

[4] Los Angeles Times, April 17, 1991, p. 1.

[5] Los Angeles Times, April 7, 1991, p. 1.

[6] Newsweek, April 22, 1991, p. 46.

[7] USA Today, April 10, 1991, p. 3B.

On April 4, 1991, the New York Department of Insurance ordered Executive Life of New York to cease writing new business until it could demonstrate that the interests of existing policyholders were adequately protected. Executive Life of New York was also ordered by the New York Department of Insurance to increase its reserves by $125 million.[8]

On April 11, 1991, John Garamendi, the California insurance commissioner, obtained a court-ordered conservatorship of Executive Life, which put Executive Life under the control of the California Department of Insurance. Subsequently, a temporary court order was obtained that authorized the California Department of Insurance to pay 100 percent of the death benefits payable under life insurance contracts and 70 percent of the annuities payable under qualified retirement plans. The California Department of Insurance was not authorized to pay cash surrender values or make loans under the contracts.

On April 16, 1991, the New York Department of Insurance took control of Executive Life of New York. Salvatore Curiale, the New York Superintendent of Insurance, announced that policyholder claims would continue to be paid in full under contracts issued by Executive Life of New York, but cash surrender values would not be paid and loans would not be made under the contracts.

The conservatorship of Executive Life is designed to allow for an equitable and orderly sale of the company and an orderly disposition of its assets.

Role of California guaranty fund

The State of California recently established an insolvency guaranty fund that is designed to provide for the indemnification of losses suffered by policyholders of insolvent life insurance companies. It is unclear whether the guaranty fund of California will cover the policyholders of Executive Life because the guaranty fund legislation excludes coverage for any company that was "insolvent" or "impaired" as of January 1, 1991.

Furthermore, even if the guaranty fund covers the losses suffered by the policyholders of Executive Life, the fund limits coverage to 80 percent of the policy amount, up to a maximum of $250,000 for death benefits and $100,000 for cash values and annuities. There is an overall $5 million limitation applicable to certain group contracts. GICs and

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8 Statement of Salvatore R. Curiale, Superintendent of Insurance of the State of New York, before the Senate Committee on Commerce, Science, and Transportation (May 7, 1991).

other less traditional insurance contracts are not covered by the California guaranty fund.

Factors contributing to insurance company insolvency

In providing life insurance or annuity protection to policyholders, life insurance companies often retain portions of premiums paid during the initial years after a policy is issued and accumulate such premiums, with investment earnings, toward the payment of benefits in later years. As the rate of return on invested assets increases, insurance companies can (1) lower policyholder premiums, (2) increase dividends paid to policyholders, or (3) lower premiums and increase dividends. Because premium rates and net costs are important competitive considerations for a life insurance company, the investment function is a significant factor in maintaining and improving a company's competitive position in the industry.

Historically, life insurance companies guaranteed and paid a relatively low rate of return on life insurance products. Life insurance policies were typically viewed only as vehicles to provide protection to a policyholder's beneficiaries in the event of an untimely death.

In the late 1970's and early 1980's, however, the life insurance industry began to compete with other financial intermediaries with more investment-oriented products. Policyholders began to demand better rates of returns on life insurance and annuity contracts. Thus, participating policies, which allow policyholders to share in the returns on investments earned by the insurance company, became more popular.

To generate investment returns that would permit life insurance companies to compete more readily with other financial intermediaries, many companies began investing assets in more risky investments than had been the historical norm for the industry. During the mid-1980's, the investment of life insurance assets in junk bonds and real estate rose significantly. Defaults by bond issuers and real estate losses have contributed to the precarious financial condition of some life insurance companies.

III. IMPACT OF INSURANCE COMPANY INSOLVENCY ON PENSION PLAN PARTICIPANTS

A. Present Law

1. Overview of qualified plans

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred. Contributions to a qualified plan are held in a tax-exempt trust.

Qualified plans are broadly classified into two categories, defined contribution plans and defined benefit pension plans, based on the nature of the benefits provided.

Under a defined benefit pension plan, benefits are specified under a plan formula. For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service completed by an employee. Benefits under a defined benefit pension plan also may be specified as a flat or step-rate (i.e., increasing with years of service) percentage of the employee's average compensation or career compensation. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan. Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. There are several different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs).

As discussed more fully below, benefits under most defined benefit pension plans are guaranteed (within limits) by the Pension Benefit Guaranty Corporation (PBGC). The PBGC does not guarantee benefits under defined contribution plans.

Qualified plans are required to meet certain standards under the Code, including rules designed to prevent discrimination in favor of highly compensated employees, rules defining age and service requirements participants can be required to satisfy before becoming plan participants, and

rules regarding the rate that benefits accrue (i.e., are earned) and become vested.

In addition, under the Code and the Employee Retirement Income Security Act of 1974 (ERISA), certain defined benefit pension plans are required to meet minimum funding standards. These standards are designed to ensure the benefit security of participants by requiring that the plan contains sufficient assets to meet plan obligations as they become due. These standards were substantially modified by the Pension Protection Act of 1987. Among the provisions of the Pension Protection Act was a requirement for an additional minimum funding contribution for plans that have current liabilities in excess of their assets (i.e., underfunded plans).

Title I of ERISA contains rules that define the standard of conduct applicable to plan fiduciaries.

2. Pension plan investments in life insurance company products

Commercial annuities or other life insurance company products may be selected or purchased by pension plan fiduciaries in a variety of situations. In the case of defined benefit pension plans, annuity contracts may be purchased (1) by an ongoing plan to satisfy the liability of the plan to a participant who has retired or otherwise separated from service; in such a case the annuity contract may be held by the plan or distributed to the retiree, (2) to satisfy plan liabilities upon plan termination, or (3) as a general investment of the plan. Some defined contribution plans provide for payments in the form of an annuity, in which case the participant's account balance will be used to purchase an annuity contract at termination of employment or later.

Pension plan assets may also be invested in guaranteed investment contracts (GICs) offered by insurance companies. GICs are investment contracts under which insurance companies, and sometimes banks, accept deposits of principal and agree to pay a fixed rate of return on the initial investment. GICs are not in fact guaranteed; the ability of the holder to recover principal and earn interest depends on the solvency of the issuer. GICs may be chosen by plan fiduciaries as a general plan investment. They are also frequently offered as an option to defined contribution plan participants who direct investment of their own account balances. In 1987, GICs constituted approximately 5 percent of all defined benefit pension plan assets, 25 percent of all profit-sharing plan assets, 30 percent of savings and thrift plan assets, and 36 percent of all section 401(k) plan assets in large corporate retirement plans.[9]

Within certain limits, qualified plans may also purchase life insurance for plan participants. For example, a participant in a defined contribution plan could purchase life insurance with a portion of his or her account balance.

3. Termination insurance program and the Pension Benefit Guaranty Corporation

In general

The Pension Benefit Guaranty Corporation (PBGC), a Federal corporation within the Department of Labor (DOL), was created in 1974 by ERISA in order to provide an insurance program for benefits under certain defined benefit pension plans maintained by private employers in the event a plan is terminated at a time when the plan does not have sufficient assets to provide benefits promised under the plan. Thus, the PBGC guarantees the payment of certain benefits in the event of the termination of a defined benefit pension plan with assets insufficient to satisfy benefit liabilities. The plan termination may be voluntary (by the employer) or involuntary (by the PBGC).[10] A termination by an employer can be either a standard termination or a distress termination.

According to the PBGC's 1990 annual report, the single-employer insurance program currently covers more than 40 million participants in approximately 93,000 single-employer defined benefit pension plans.[11] PBGC revenues include premiums charged with respect to defined benefit pension plans, earnings on investments, and collections from sponsors of plans that are terminated with assets insufficient to pay all benefits under the plan.

As of September 30, 1990, the PBGC had assets of approximately $3.3 billion and liabilities of about $5.1 billion, resulting in an accumulated deficit of $1.8 billion. As of September 30, 1989, the PBGC's deficit was approximately $1 billion. In its 1990 annual report, the PBGC attributes the increase in its deficit to increased losses from plan terminations.

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[9] Source: "Large Corporate Pensions 1987, Report to Participants," Greenwich Associates (1987).

[10] The PBGC can commence a termination of a plan if the plan (1) does not satisfy minimum funding requirements, (2) cannot pay benefits when due, (3) made certain distributions to substantial owners, or (4) is in such a condition that the long-run loss to the PBGC is expected to increase unreasonably unless the plan is terminated.

[11] The PBGC also covers multiemployer pension plans.

Covered plans

The PBGC insures most tax-qualified defined benefit pension plans established or maintained by an employer (or employee organization) engaged in commerce or in any industry or activity affecting commerce. Plans that are not insured by the PBGC include: (1) defined contribution plans; (2) plans maintained by the Federal Government or by State or local governments; (3) plans maintained by churches; and (4) plans established and maintained by a professional service employer that does not at any time have more than 25 active participants.

Guaranteed benefits

Subject to limits, the PBGC guarantees basic benefits under a covered plan (ERISA sec. 4022). With respect to single-employer defined benefit pension plans, basic benefits consist of nonforfeitable retirement benefits other than those benefits that become nonforfeitable solely on account of the termination of the plan. Guaranteed benefits are limited to basic benefits of $750 per month adjusted for inflation since 1974 ($2,250 for 1991).

Guarantees do not apply with respect to benefits in effect for fewer than 60 months at the time of plan termination unless the PBGC finds substantial evidence that the plan was terminated for a reasonable business purpose and not for the purpose of securing increased guaranteed benefits for participants. In cases in which such benefits are guaranteed, the guarantee is phased in over 5 years at the rate of $20 per month or 20 percent per year, whichever is greater, for (1) basic benefits that have been in effect for less than 60 months at the time that the plan terminates, or (2) any increase in the amount of basic benefits under a plan resulting from a plan amendment within 60 months before the date of plan termination.

The PBGC is authorized under ERISA to guarantee the payment of other classes of benefits (i.e., nonbasic benefits) and to establish the terms and conditions under which such other benefits are guaranteed. To date, the PBGC has not exercised this authority.

PBGC premiums

In order to cover the cost of PBGC guarantees, premiums are imposed with respect to covered plans. A flat-rate PBGC premium of $19 per participant applies to single-employer defined benefit pension plans. An additional variable-rate premium based on a plan's funded status is imposed with respect to underfunded plans. The additional per-participant premium for years beginning after December 31, 1990, is $9 per $1,000 of the plan's unfunded vested benefits divided by

the number of participants, with a maximum per-participant additional premium of $53 (i.e., a total possible premium of $72) (ERISA sec. 4006). Special rules apply with respect to the interest rate used to value unfunded vested benefits.

Both the plan administrator and the contributing sponsor of the plan (i.e., the employer) are liable for the premium. Further, if the contributing sponsor is a member of a controlled group, each member of the controlled group is jointly and severally liable for the premium.

For purposes of determining the amount of premiums due, PBGC regulations generally define a "participant" as (1) an individual (whether or not currently employed by the employer) who is earning or retaining credited service under the plan, (2) an individual who is retired or separated from service and who is receiving or is entitled to receive a benefit under the plan, and (3) a deceased individual who has one or more beneficiaries who are receiving or entitled to receive benefits under the plan (PBGC reg. sec. 2610.2). Under the regulations, the term participant does not include an individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the individual is entitled under the plan. The term participant also does not include an individual who has received a distribution of his or her total interest in the plan, for example, in a lump-sum distribution. The premium due for a year is based on the number of participants in the plan on the last day of the preceding plan year.

The obligation to pay PBGC premiums ceases at the end of the year in which plan assets are finally distributed pursuant to a plan termination. The plan may obtain a refund for amounts paid for the year the plan's assets are so distributed and after the later of (1) the date the assets are distributed, or (2) 30 days before the PBGC receives a certification that the distribution is made. (PBGC reg. sec. 2610.22(d)).

<u>Termination procedures</u>

A defined benefit pension plan is generally considered terminated when it is voluntarily terminated by the employer or involuntarily terminated by the PBGC. A plan may be terminated voluntarily only in a standard or distress termination (ERISA sec. 4041).

A standard termination is permitted only if the plan has sufficient assets to satisfy benefit liabilities under the plan. Benefit liabilities are, in general, all fixed and contingent liabilities to plan participants and beneficiaries earned as of the date of the termination of the plan (i.e., those liabilities described in Code sec. 401(a)(2)).

A plan may be terminated in a distress termination if the plan lacks sufficient assets to satisfy benefit liabilities and the employer meets certain requirements relating to financial distress. In the case of a distress termination, the PBGC will generally take responsibility for payment of benefits under the plan.

Plan termination procedures were substantially revised in the Single Employer Pension Plan Amendments Act of 1986 (SEPPAA). Under SEPPAA, a plan may be terminated in a standard termination if: (1) the plan administrator provides 60-day advance notice of the intent to terminate to plan participants and other affected parties; (2) as soon as practicable after the 60-day notice is provided the plan administrator (a) sends to the PBGC an actuarial certification that the plan has sufficient assets to cover benefit liabilities and certain other information, and (b) notifies each participant and beneficiary of their share of benefit liabilities; and (3) the PBGC does not issue a notice of noncompliance with regard to the termination.

The PBGC is authorized to issue a notice of noncompliance if it determines that the standard termination procedures have not been satisfied or that the plan's assets are not insufficient to meet benefit liabilities. The PBGC has 60 days after the plan administrator notifies the PBGC of the proposed termination to issue a notice of noncompliance. This 60-day period may be extended by written agreement of the plan administrator and the PBGC.

If the PBGC does not issue a notice of noncompliance, the plan administrator is to proceed as soon as practicable with the final distribution of plan assets. In distributing plan assets, the plan administrator is to follow certain rules relating to the allocation of plan assets (ERISA sec. 4044). Further, the plan administrator is to purchase irrevocable commitments from an insurer to provide for all benefit liabilities under the plan or (in accordance with the provisions of the plan and any regulations) otherwise fully provide all benefit liabilities under the plan (e.g., pay a lump sum amount to a participant provided payment in such form is otherwise permitted under the Code and ERISA).

Under PBGC proposed regulations, the irrevocable commitment from an insurer must be a single premium, nonparticipating (except in the case of a plan that is sufficient for all accrued benefits), nonsurrendable annuity that constitutes an irrevocable commitment by the insurer to provide the benefits purchased (PBGC proposed reg. sec. 2617.6). The plan administrator is required to give the participant or beneficiary the annuity contract or a certificate showing the insurer's name and address and clearly reflecting the insurer's obligation to provide the participant's or beneficiary's benefit (PBGC proposed reg.

sec. 2617.18(c)). Neither the statute nor regulations require that the insurance company providing the irrevocable commitment meet specific standards except that the insurer must be a company authorized to do business as an insurance carrier under the laws of a State or the District of Columbia.

Within 30 days after the final distribution of assets is completed, the plan administrator is to certify to the PBGC that the plan's assets have been distributed to pay all benefit liabilities under the plan. Under proposed PBGC regulations, the certification is to include the name and address of the insurer from which annuity contracts were purchased. The PBGC has indicated that it will require that the PBGC be provided with the name of the insurer prior to the final distribution of assets.

Extent of PBGC guarantee upon distribution of annuity contracts

ERISA does not explicitly state whether or not the PBGC guarantee extends to commercial annuities distributed to a plan participant in satisfaction of the plan's obligation for benefits. In the case of an annuity contract distributed from an ongoing plan, the PBGC guarantee would generally not apply, because the guarantee does not come into play until a plan is terminated. In the case of commercial annuities distributed pursuant to a plan termination, the current position of the PBGC and the DOL is that the guarantee does not apply in such circumstances because the participant has received his or her total benefits under the plan.[12]

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[12] The PBGC has previously indicated that the guarantee might apply. The preamble to the final regulations issued in 1981 (PBGC reg. sec. 2615) relating to the conditions under which the PBGC would issue a notice of sufficiency upon plan termination (prior to the enactment of SEPPAA) included the following in its discussion of the provision in the regulations concerning the requirement that benefits payable as annuities be provided in annuity form either by the PBGC or through the purchase of annuity contracts from an insurer:

> Under the regulation, an "insurer" is "a company authorized to do business as an insurance carrier under the laws of a State or the District of Columbia" (sec. 2615.2). Such companies are subject to strict statutory requirements and administrative supervision. In fact, the reason insurance companies are so extensively regulated is to ensure that their obligations can be satisfied. However, in the unlikely event that an insurance company should fail and its obligations cannot be satisfied (e.g., through a reinsurance system), the

(Footnote continued)

There is some support under present law for the position that the guarantee does extend to commercial annuities distributed to plan participants. One could argue that the guarantee is not terminated when the benefit obligation is merely transferred to a third party (e.g., an insurance company), as opposed to being distributed to the plan participant (e.g., in a lump-sum distribution). Further, under ERISA, the PBGC is granted continuing authority to take certain actions after a plan has terminated and plan assets have been distributed (e.g., to bring a civil suit to enforce the termination under ERISA).

ERISA also provides that the certification by the plan administrator that the assets have been distributed and all benefit liabilities satisfied does not affect the PBGC's obligations under the provisions of ERISA relating to benefit guarantees (ERISA sec. 4041(b)(4)). While one reading of this provision would support the view that the PBGC remains liable for guaranteed benefits after a plan terminates and annuities have been distributed, the legislative history relating to the provision suggests a more modest purpose--to extend the PBGC guarantee to those situations in which it is subsequently determined that the certification was incorrect and all guaranteed benefits were not in fact distributed.[13]

In support of the PBGC's current position, it may be

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[12](continued)
PBGC would provide the necessary benefits.

46 Fed. Reg. 9532, at 9534. This position is not necessarily consistent with the structure of the PBGC premium.

[13] This section of ERISA was added by SEPPAA. The legislative history to SEPPAA included the following explanation of the provision:

> Under the bill, the PBGC retains its existing authority under section 4003 of ERISA to conduct audits of plans, both prior to and after the termination of a plan. Even if the plan administrator has certified to the PBGC that the assets of the plan have been distributed so as to provide when due all benefit entitlements and all other benefits to which assets are allocated under section 4044, the PBGC is still obligated to guarantee the payment of benefits under section 4022 if it is subsequently determined that not all guaranteed benefits were in fact distributed under a standard termination, and the contributing sponsors of the plan and the members of their controlled groups do not promptly provide for the payments of such benefits.

H. Rpt. 241, 99th Cong., at 48.

argued that the trigger for the insurance, i.e., the insurable event, is the plan termination. Once the benefits of plan participants have been provided for, the PBGC is no longer liable. Under this argument, the obligation of the plan to provide the benefit has been met when there has been a distribution of an annuity contract to the participant. The distribution of the contract satisfies the liability in the same manner as a lump sum would satisfy the liability of the plan if the participant requested such a distribution. Under this view, the PBGC has no further obligation if an annuity contract is distributed just as it has no further obligation if, for example, a former participant invested a lump-sum distribution in an IRA or used the distribution to purchase an annuity on his or her own.

It may also be argued that the premium structure of ERISA does not contemplate a continuing obligation with respect to the PBGC after the termination of the plan and the distribution of plan assets. If the guarantee continues, then the premium should take into account the risk of the failure of the insurance company, not simply the risk that plan assets are not sufficient for benefit liabilities. Moreover, present law does not contain rules that would be necessary to coordinate such a continuing obligation with State laws regulating insurance providers and products.

4. Standards for plan fiduciaries and insurers

Fiduciary rules

ERISA imposes certain standards of conduct on plan fiduciaries. Under ERISA, a fiduciary is required to discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying the reasonable expenses of administering the plan.[14] In addition, a plan fiduciary is required to discharge his or her duties (1) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in a similar enterprise, (2) by, in general, diversifying the investments of the plan so as to minimize the risk of large losses, and (3) in accordance with the plan document and other governing instruments insofar as such documents are consistent with ERISA.[15]

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[14] A similar rule is included in the Internal Revenue Code. A plan will not be qualified if it is possible, at any time prior to the satisfaction of all liabilities under the plan, for any plan assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries (sec. 401(a)(2)).

A fiduciary is generally defined as a person who, with respect to a plan (1) exercises any discretionary authority or discretionary control respecting management of the plan or exercises any authority or control respecting management or disposition of plan assets, (2) renders investment advice with respect to plan assets for a fee or other compensation, or (3) has discretionary authority with respect to the administration of the plan.

If a fiduciary fails to meet ERISA's standards of conduct, the fiduciary is personally liable for any losses resulting from the breach of fiduciary duty. The Secretary of Labor, the plan administrator, and participants or their beneficiaries are permitted to bring an action against the fiduciary. Civil and criminal penalties may also apply.

Courts, as well as the DOL, have generally taken the position that the decision to terminate a plan is a settlor function (i.e., made in the discretion of the employer who is the plan sponsor) and is not subject to ERISA's fiduciary rules.[16] However, the selection and purchase of annuities by an ongoing plan or on plan termination is viewed by the DOL as an investment decision subject to the fiduciary standards.[17] Thus, for example, the selection by a plan sponsor of an insurance company from which to purchase annuities on plan termination could be challenged on the ground that the employer did not act solely in the interests of plan participants but acted only to maximize the employer's reversion. The DOL has not issued any specific standards regarding annuity providers.

As discussed above, plans may invest in commercial annuities in situations in addition to the termination of a defined benefit pension plan. The fiduciary rules may apply differently in other situations. For example, if a defined contribution plan plan permits a participant to exercise control over the assets in his or her account and the participant exercises such control, then, in general, no person who otherwise is a fiduciary is liable for losses which result from the participant's control of his or her account (ERISA sec. 404(c)). Thus, for example, a fiduciary

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15 There are additional rules under the Code and ERISA relating to fiduciaries who engage in certain prohibited transactions with a plan (e.g., self-dealing) (Code sec. 4975 and ERISA sec. 406).

16 See, e.g., U.A.W. District 65 v. Harper & Row, Inc., 576 F. Supp. 1468 (S.D.N.Y. 1983).

17 The Department of Labor has taken this position in an opinion letter to the Advisory Council on Employee Welfare and Pension Benefit Plans dated March 13, 1986.

may not be liable where the participant has directed the investment of his or her account under a qualified cash or deferred arrangement (Code sec. 401(k)) and the performance of such investment is unsatisfactory. However, this exception to fiduciary liability does not apply with respect to the selection of the investment options available to the participant. Consequently, if, for example, the options are not sufficiently diversified, the fiduciary may be liable.

<u>PBGC termination procedures</u>

The PBGC has not issued final regulations regarding the post-SEPPAA termination procedures. The proposed regulations under the post-SEPPAA rules do not contain specific rules regarding selection of the annuity provider, other than that the insurer be authorized to do business as an insurance carrier under State law or in the District of Columbia.

As mentioned above, the proposed regulations under the post-SEPPAA rules provide that the certification required following final distribution of plan assets is to contain the name of the insurance company providing annuities. The PBGC has indicated that it will revise this procedure to require that the name of the company be provided before the distribution of assets. The PBGC has informally indicated that this additional period of time is intended to give the PBGC the opportunity to refer appropriate cases to the Pension and Welfare Benefits Administration (an agency within the Department of Labor) for examination under the fiduciary rules. The PBGC has not issued a formal notice regarding this procedure, or indicated what criteria it will use in referring cases for further examination.

<u>State insurance laws</u>

ERISA generally preempts State laws as they relate to any pension plan (ERISA sec. 514). This provision does not, however, apply to any State law regulating insurance. Thus, providers of annuities to terminating defined benefit pension plans are subject to whatever standards apply under State law.

A majority of States have established guaranty funds that are designed to cover the liabilities of failed insurance companies. While State laws relating to guaranty funds differ, these funds may provide some protection to defined benefit pension plan participants who hold a commercial annuity.

B. Issues

1. Potential for loss of pension benefits because of insurance company insolvency

The extent to which pension plan participants may lose benefits due to the insolvency of an insurance company in whose products plan assets have been invested depends in part on the type of plan and the circumstances under which the product or contract is purchased. In many cases, the PBGC does not guarantee benefits, so that the extent of loss will depend on the liability of the employer or other plan fiduciaries to make up the losses, and the extent of State-law guarantees.

Plan participants have the greatest protection if the insurance company product is a general investment of an ongoing defined benefit pension plan, for example, if the plan invests in a GIC. If the insurance company becomes insolvent or a loss on the investment otherwise occurs and the plan is not adequately funded, the employer will be required under the minimum funding rules to make additional contributions to the plan over time to account for the loss. This would occur in the case of any investment loss suffered by the plan. If the plan subsequently terminates and plan assets are insufficient to provide benefits, then the PBGC will pay benefits up to the guaranteed levels. If the investment involved a breach of fiduciary duty, then the responsible fiduciary would be liable for any losses.

It is unclear whether a participant has any recourse for loss of benefits if an annuity contract has been purchased by a defined benefit pension plan in satisfaction of plan liabilities for benefits. The PBGC does not guarantee benefits that have been provided by annuity contracts. Thus, participants will be able to recover lost benefits only through participant lawsuits, or State guaranty funds.

Participants may attempt to recover from the employer or plan fiduciaries by arguing that (1) the purchase of the contract was not sufficient to satisfy the plan's obligation to provide benefits, or (2) that the responsible plan fiduciary breached his or her duty in purchasing the contract. Whether a participant can prevail as a matter of law on the first argument is unclear; the second will be a question of fact depending on the actions of the plan fiduciary. The fact that an insurance company becomes insolvent does not mean that there has been a breach of fiduciary duty--if at the time of purchase the annuity contract was a reasonable decision and the choice of insurers was reasonable, then the fiduciary is generally not responsible for subsequent losses.

If participants must rely on State guaranty funds, participants in different States may receive different levels of benefits because the extent of State guarantees differs from State to State. State guaranty funds are discussed further in Part IV.

In the case of defined contribution plans, the minimum funding rules do not require the employer to make up plan losses, nor does the PBGC guarantee apply. Thus, participants will be able to recover lost benefits only by attempting to recover from appropriate fiduciaries or through State guaranty funds. The ability to recover from plan fiduciaries may be limited if the individual has directed the investment in the insurance company product. In such cases, the fiduciary is only responsible for the range of investment options provided to the participant, and is not responsible for any losses because the participant picked a particular investment.

2. Taxation and plan qualification issues

Insurance company insolvency can also affect the taxation of distributions received by plan participants, and raises a number of issues relating to continued qualification of the plan. While some of these issues have been addressed in other contexts, many of them are new.

Under present law, plan participants may roll-over total distributions of plan benefits tax free to an individual retirement account (IRA) or another qualified plan. Partial distributions may also be rolled over to an IRA if (1) the distribution is made after separation from service, (2) it consists of at least 50 percent of the balance to the credit of the employee, and (3) the distribution is not one of a series of periodic payments. In addition, certain lump-sum distributions are eligible for 5- or 10-year income averaging. The ability of plan participants to take advantage of these tax rules may be affected by the Executive Life situation.

For example, suppose a portion of the account balance of a participant in a defined contribution plan is invested in GICs with Executive Life. The participant terminates employment and requests a distribution of his entire account balance.

The plan could have a variety of responses, including: (1) making a good faith valuation of the Executive Life GICs (which may or may not be correct) and making a total distribution to the participant based on that valuation; (2) distributing the portion of the account that is not attributable to the GICs and holding the remainder of the account until its value can be determined; or (3) suggesting that the participant wait until the Executive Life matter is resolved. The choice of the plan (and the participant) could affect the taxation of the distribution.

For example, if the plan attempts to value the GICs and the valuation is incorrect, the distribution may not qualify as a lump sum, in which case the distribution would not

qualify for averaging. Similarly, if the plan decides to make two separate distributions, it is not clear if either will qualify for averaging. Whether or not the distributions could be rolled over will depend on the amount of the account balance invested in the GICs and also on the IRS interpretation of the periodic payment rule. Certainly, the fact that distributions are made in more than one taxable year does not mean that they are periodic payments.

The participant could avoid these uncertainties by waiting to take a distribution until the matter is resolved. However, the financial circumstances of the individual may not make that feasible.

A variety of other issues may also be of concern to plan participants and fiduciaries. The qualification rules require that minimum distributions be made from qualified plans starting when the participant attains age 70-1/2. A 50-percent excise tax is imposed on the difference between the amount required to be distributed to the participant and the amount actually distributed. The difficulty in valuing Executive Life GICs may create difficulties in ensuring that the minimum distribution rules are satisfied, and may expose participants to the excise tax. Further, the court order currently applicable to Executive Life permits the payment of only 70 percent of the retirement annuities purchased by qualified plans. Thus, under certain circumstances, the court order might prevent the payment of annuity benefits that are otherwise required to be paid to satisfy the minimum distribution rules.

Some employers may wish to make up the difference between payments of Executive Life GICs and annuities. If the employer does so, it is not clear whether such a payment would be treated as a plan contribution or a payment outside the plan. If it is a contribution, it is subject to the deduction limits on plan contributions, and the limits on individual benefits and contributions. The limits on benefits and contributions may prevent the employer from making up the entire difference in a single year or ever. If a payment is made outside of the plan, then the qualification rules would not limit the amount of the payment, but the taxation of the payment to the participant would vary. For example, the payment could not be rolled over and would not be taken into account in determining whether the minimum distribution rules are satisfied.

Pending clarification of these and other issues, plan participants, sponsors, and fiduciaries may be faced with substantial uncertainty in attempting to deal with the Executive Life conservatorship and similar situations.

IV. IMPACT OF INSURANCE COMPANY INSOLVENCY ON NONPENSION ANNUITANTS AND BENEFICIARIES OF LIFE INSURANCE PRODUCTS

In general

Unlike the case with certain pension plan participants and beneficiaries and account holders of Federally insured financial institutions, the Federal Government does not guarantee or otherwise protect the claims of policyholders or beneficiaries of products of life insurance companies. This lack of Federal protection occurs at least in part because the regulation of the insurance industry has historically rested with the States.

Most State governments have adopted State guaranty funds that are designed to indemnify policyholders for the losses incurred when an insurance company becomes insolvent. The State guaranty funds may provide for the payment of claims or cash values or may provide for the continuation of policies held by the insolvent company. All States except Colorado, Louisiana, New Jersey, and the District of Columbia have some form of guaranty fund, However, the extent to which benefits are protected by the State guaranty funds varies from State to State. Most States have some limit on the amount of the guaranty fund protection.

The types of guarantees for which State funds may provide payment include (1) payments under annuity contracts, including payments made pursuant to structured settlement agreements, (2) claims under health insurance policies, and (3) death benefits or cash surrender values with respect to life insurance contracts.

Impact of Executive Life insolvency

If it is determined that Executive Life is unable to pay all claims relating to its liabilities to policyholders, then State guaranty funds may be tapped to satisfy Executive Life's obligations. However, the State guaranty funds have generally been structured to address insolvencies by relatively small insurance companies and the obligations of Executive Life may exceed State guaranty fund balances.

V. PROPER SCOPE OF FEDERAL GUARANTEES AND REGULATION OF INSURANCE COMPANIES AND PRODUCTS

A. Issues Related to Federal Guarantees

To help analyze whether, and under what conditions, Federal guarantees of pension benefits funded through insurance companies or of other insurance company products (e.g., life insurance contracts, annuity contracts, and structured settlement agreements) should be provided, this section discusses (1) the scope of Federal guarantees of pension benefits, (2) whether the Federal Government or the States should provide guarantees of pension benefits or insurance products, (3) the pricing of Federal insurance, including factors affecting pricing of insurance of benefits provided directly by a pension plan, and (4) the problems resulting from inadequate pricing.

1. Scope of Federal guarantees of pension plans

Solvency of employer

Under present law, the Federal Government's guarantee of pension benefits (through the operations of the PBGC and the plan termination insurance program) is relatively limited. The guarantee does not extend to defined contribution plans, does not guarantee all benefits under a defined benefit pension plan, and is not triggered until a defined benefit pension plan is terminated.[18]

The plan termination insurance program was initially enacted in response to a large plan termination in which insufficient assets were available to pay promised benefits to plan participants under a defined benefit pension plan. The primary need for the insurance program was deemed to be the termination of defined benefit pension plans because any participant's contractual right under the plan was the right to plan benefits, rather than to a portion of plan assets or to an account balance in the participant's name. Once a plan terminated, the employer might no longer be willing or available to pay the promised benefits if assets were insufficient at the time of termination. The plan termination insurance program was designed to provide a backstop to satisfy employee expectations that a specified plan benefit would be paid after retirement.

Under the present-law system, the Federal Government regulates the minimum funding of defined benefit pension

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[18] The PBGC can control the occurrence and the timing of termination of a defined benefit pension plan under certain circumstances.

plans. This Federal regulation is another reason why the Federal guarantee of pension benefits generally is triggered only upon plan termination when plan funding stops. The primary concern under present law is the ability of an employer to discharge voluntarily its liabilities with respect to the defined benefit pension plan upon plan termination.

Arguments could be made for expanding the scope of the Federal guarantee to additional cases. For example, some might consider the solvency of an employer to be a more telling indicator of the potential inability to provide promised benefits than the solvency of the defined benefit pension plan. Thus, the employer's insolvency might hamper it's ability to fund the defined benefit pension plan, which would threaten the security of participants' benefits. This problem argues for a premium related to the solvency of the employer rather than to the funded status of the plan.

Also, as defined contribution plans become more popular and replace defined benefit pension plans, issues arise as to the potential declines in value of assets allocated to a participant in a defined contribution plan. This loss could occur because of the trustee's investment decisions or because of the employee's investment decisions when self-directing of investments is permitted. Thus, the Federal guarantee could appropriately be extended to cases in which participants might otherwise face a risk of loss of benefits beyond the traditional event of plan termination.

<u>Solvency of insurance company</u>

A new issue also arises with respect to the payment of pension benefits--the extent to which the Federal Government guarantee of pension benefits should extend to situations in which the employer is no longer liable for plan benefits or has transferred its responsibility to an insurance company. Such an extension could significantly broaden the potential scope of the Federal guarantee.

The element of this issue that is most analogous to the present-law plan termination insurance program occurs when an employer purchases an annuity contract for a plan participant that is distributed to the participant upon plan termination in satisfaction of the employer's liability to the participant.[19] Once the annuity contract is purchased, the insurance company has stepped into the shoes of the employer

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[19] Some argue that payments under the annuity contract purchased by the employer are guaranteed by the PBGC under present law. (See the discussion in present law, Part III.A.3., above.)

with respect to the liability to pay benefits to an employee. If the insurance company is unable to satisfy its liabilities to policyholders, the employee may not receive the promised benefits.

In this situation, it is necessary to determine the potential problems that extension of the Federal guarantee would address. Thus, the concern that extension of the Federal guarantee would address must be the potential inability of an insurance company to satisfy its liabilities. Even in the case of the annuity contract purchased on termination of a defined benefit pension plan, the extension of the Federal guarantee to the failure of the insurer to satisfy its liabilities could be considered a significant expansion of the original plan termination insurance program.

If the expansion of the Federal guarantee to holders of annuity contracts after plan termination is considered appropriate, then questions arise as to whether additional situations should be entitled to a similar guarantee. For example, some employers satisfy the funding requirements of their defined benefit pension plans by purchasing annuity contracts--these plans are referred to as fully insured plans. Plan termination as the triggering (i.e., insurable) event in the case of such a plan may not adequately protect plan participants whose benefits are tied directly to the solvency of the insurance company that issued the contracts. Thus, it may be necessary to consider expansion of the Federal guarantee to situations in which the potential financial failure of an insurance company could result in a loss of pension benefits.

If the solvency of the insurance company is a principal concern in evaluating the scope of Federal guarantees for pension benefits, then a similar problem may arise when an employer purchases an annuity contract on behalf of a retiring employee. This issue will arise whether or not the contract is distributed to the employee as long as the contract removes the employer's liability with respect to the employee.

2. Federal versus State guarantees

Under present law, the Federal Government assumes responsibility for the guarantee of pension benefits upon the termination of a defined benefit pension plan with assets that are insufficient to pay liabilities. However, in the case of the insolvency of an insurance company, the Federal Government is not involved because the regulation of the insurance industry has traditionally been left to the States. In addition, some States have enacted guaranty fund programs to insure the liabilities of insolvent insurance companies.

It must be determined whether the Federal guarantee of

pension benefits should be extended to the loss of pension benefits or to the loss of other benefits (such as life insurance contract death benefits) due to the insolvency of an insurance company. If the Federal guarantee is extended in certain circumstances, the Federal Government could be at risk to bear significant losses because of the Federal Government's traditional lack of involvement in the regulation of the insurance industry. Thus, the States may not be fully cognizant of, or may not be sensitive to, the potential loss to the Federal Government if regulation of the industry is lax. An example of the problems created by Federal guarantees coupled with State regulation of a particular industry is the savings and loan crisis. Thus, it may be determined necessary for the Federal Government to intervene in the regulation of the insurance industry in order to protect against significant losses. In the case of an extended Federal guarantee of pension benefits, assuming that the premiums charged by the PBGC will be adjusted to reflect the expanded scope of the Federal guarantee, the amount of the PBGC premium to be charged and to whom will be significant issues.

The primary advantage of Federal regulation of the insurance industry would be the uniformity of rules. This advantage must be balanced against the traditional role of the States in the regulation of insurance and the significant additional burden that would be imposed on the Federal Government.

In addition, certain States maintain guaranty funds under present law that are designed to protect the policyholders of insurance companies in the event of company insolvency. If Federal guarantees are extended in certain cases, then it would be necessary to consider how the Federal guarantee interacts with a State guarantee fund. Would the State guarantee apply in addition to, or in lieu of, the Federal guarantee?

It might also be appropriate for the Federal Government to encourage the States to develop uniform guaranty fund rules that would eliminate the potential need for Federal Government guarantee of payment to life insurance company policyholders and beneficiaries.

3. Pricing of Federal guarantee insurance

In general

Given a specified amount of insurance coverage, the primary factor in determining the correct price of insurance is the expectation that such coverage will actually be utilized.[20] Whenever it is possible to differentiate between amounts of risk, a system of risk-based premiums is preferable to a system of premiums not adjusted for risk.

For defined benefit pension plan participants, risks to future benefits are mainly determined by the prospects for continuing financial soundness of the benefits provider. Defined benefit pension plan benefits can generally be provided in two ways--directly from the trust established to fund the plan or by a commercial annuity purchased with trust assets.

For life insurance company policyholders or defined contribution plan participants whose account is invested in GICs, risks to future benefits are determined solely by reference to the financial stability of the insurance company issuing the policy contract or a reinsurance company that assumes the liability.

Benefits paid by pension trust assets

In general

In the case of pension benefits provided by employers through defined benefit pension plans, the primary factor in determining full realization of benefits is the degree to which the trust established under the plan is funded. The financial soundness of the trust, and therefore the premiums for insurance coverage of the benefits funded by the trust, depend on such factors as the amount of assets relative to projected liabilities (the "funding level" or "funding ratio"), the riskiness of assets held by the trust, and the ability of the employer to make future contributions to the plan.

Funding levels

A substantial practical problem in determining the appropriate risk-based insurance premiums for pension benefits funded by defined benefit pension plan trusts is the difficulty in establishing the adequacy of pension plan funding. For pension plans to be considered fully funded, the value of fund assets must equal or exceed accrued pension liabilities.[21] Pension liabilities equal the present value of future benefits owed for plan participants. One manifestation of the liability-valuation problem is the variety of accepted methods and assumptions that may be used

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[20] In economic terms, the correct pricing of insurance requires the expected present value of future premiums to equal the expected present value of future benefits.

[21] Another possible measure of the funded status of a plan is the extent to which plan assets are sufficient to cover the present value of projected, rather than accrued, liabilities.

in determining the value of future pension benefits both for funding purposes under the Code and ERISA and for financial reporting purposes. With regard to methods, it useful to distinguish between two general types: those measures which calculate pension benefits assuming employees' anticipated future levels of compensation and the narrower measures which calculate benefit levels based on current levels of employee compensation. With regard to assumptions, a critical assumption is the interest rate used for valuation of these liabilities. The present-law variable rate PBGC premium structure has attempted to deal with some of these issues, for example, by specifying the interest rate used to calculate vested unfunded benefits.

Data on funding of defined benefit pension plans from Forms 5500 filed by plans with the DOL and the Internal Revenue Service indicate that funding ratios have improved substantially since ERISA was enacted. Since 1974, plans with full funding status have increased from 35 to 73 percent. These data are based on liabilities calculated using the plans' own actuarial assumptions and a method calculating accrued benefits assuming current employee levels of compensation. Such a method is generally referred to as valuation on a "termination basis," i.e., under the assumption that the plan had been terminated. The same data also show that assets held by plans in 1985 had value equal in the aggregate to 116 percent of the value of liabilities.[22] Although these data indicate that pension plans have a surplus in the aggregate, underfunded plans had a total shortfall of $60 billion in 1985.[23] Statutory changes enacted in 1986 and 1987 affecting allowable funding methods and assumptions used in calculating defined benefit pension plan liabilities have generally raised minimum funding standards and reduced the discretion of plan sponsors in choosing methods of calculating liabilities.

A variety of funding methods and assumptions are also allowed for financial reporting purposes. Standards for financial reporting have also been raised.[24] As an indication of the potential variability arising from the use

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[22] See Deloris V. Stevens (1989), "Funding Status of Private Pension Plans, 1985: Termination Funding Ratios," in U.S. Department of Labor, Pension and Welfare Benefits Administration, Trends in Pensions, Washington, D.C., pp. 119-136.

[23] See Arnold J. Hoffman (1989), "Funding Levels of Private Defined-Benefit Pension Plans by Industry, The Relationship between Output, Employment, and Funding 1985: Termination Funding Ratios," in U.S. Department of Labor, Pension and Welfare Benefits Administration, Trends in Pensions, Washington, D.C., pp. 137-152.

of different assumptions and methods, it is useful to note the results of one study that reports the different defined benefit pension plan liabilities calculated under different methods. Performing simulations on data obtained from Form 10-K financial statement data filed with the Securities and Exchange Commission, the study shows that under previous financial reporting standards, 59 percent of plans were underfunded in 1981 and 79 percent of plans were underfunded in 1987; under these same rules, total defined benefit pension plan assets equaled 145 percent of estimated liabilities in 1987. Under recently revised rules, 54 percent of plans were underfunded in 1981 and 60 percent of plans were underfunded in 1987; under these same rules, total defined benefit pension plan assets equaled 110 percent of estimated liabilities in 1987.[25]

Financial soundness of the employer

If a defined benefit pension plan does not have sufficient assets to fund liabilities fully, the financial condition of the plan sponsor and members of the sponsor's controlled group is also an important determinant of the potential PBGC liability. To the extent that the plan sponsor has the ability to make contributions to the plan, the PBGC's liability is reduced. At least one study has shown that firms with low profits use assumptions about valuation interest rates which are more likely to result in lower reported pension liabilities.[26]

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[24] In 1980, the Financial Accounting Standards Board (FASB) issued Statement 36 which mandated reporting of accrued pension liability and market value of pension assets in a footnote to the balance sheet of a plan sponsor's financial statements. Under the methods of FASB Statement 36, future salary and benefit increases were not considered in the benefits calculation, and a wide range of valuation interest rates could be used. Financial accounting standards for defined benefit pension plans were substantially revised in 1985 when the FASB issued Statement 87. Under these new rules, which are mandatory by 1989, unfunded pension liability must appear on the balance sheet, rather than in a footnote. In addition, under Statement 87, pension liabilities must be calculated with and without taking account of projected salary increases and the valuation interest rate must be the settlement rate used by insurance companies or the PBGC valuation rate.

[25] See Michael J. Warshawsky (1989), "The Adequacy of Funding of Defined Benefit Pension Plans," in U.S. Department of Labor, Pension and Welfare Benefits Administration, Trends in Pensions, Washington, D.C., pp. 137-152.

Because the ultimate liability of the PBGC may depend on the solvency of the plan sponsor, some have suggested that a risk-related premium should reflect the financial position of the employer. On the other hand, some argue that such a premium would be difficult to calculate and would be inappropriate if the employer's defined benefit pension plan is otherwise adequately funded. In addition, some argue that higher premiums would be inappropriate for an employer already experiencing financial difficulty.

Annuities and other benefits provided by life insurance companies

Pension benefits

The transfer of defined benefit pension benefit liability from benefit plan trusts to insurance companies issuing pension annuities significantly changes the nature of the financial risk faced by plan participants. In the case of an underfunded plan, such a transfer may reduce the risk of loss of a given level of benefits to the participant if it is more likely that the plan sponsor will become insolvent than that the life insurance company issuing the annuity contract will. However, this risk of loss may be increased in the case of a plan sponsored by a financially sound employer, particularly if the insurance company is not financially sound.

In the case of defined contribution plan investments in insurance companies, the participants' risk is always the soundness of the insurance company.

Risk-based premium for life insurance companies

A risk-based premium for insuring annuities and (including pension annuities) and life insurance benefits and investments would be based on the financial condition of the life insurance company, which could be measured by its capital, quality of assets, and various financial ratios. Currently, the regulation of the financial condition of private insurance companies is primarily the responsibility of the States. Thus, unless Federal rules for regulating insurance companies were adopted, a risk-based Federal insurance premium would be heavily dependent upon State regulatory practices. State regulatory practices are in varying degrees influenced by the views of the National Association of Insurance Commissioners (NAIC), which plays a

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[26] See Zvi Bodie et al. (1987), "Funding and Asset Allocation in Corporate Pension Plans: An Empirical Investigation," in Zvi Bodie, John Shoven, and David Wise, eds., Issues in Pension Economics, University of Chicago Press.

major role in the coordination of reporting standards and regulation among the States.

In addition to State regulation of the financial condition of life insurance companies, existing insurance mechanisms at the State level could also be a factor in the pricing of a Federal risk-based premium. All but three States and the District of Columbia have some form of guarantee law that provides indemnification of losses suffered by policyholders of insolvent companies. Funds for indemnification are generally derived from assessments against solvent companies. Coordination of State and Federal law would be necessary to ensure that State law did not undermine Federal policy, and also to avoid unduly burdensome or conflicting rules for insurance companies.

Timing of premium payments for Federal guarantees

In general, the timing of insurance premiums may be determined under a wide variety of payment schedules. For example, insurance premiums may be paid in equal amounts over the life of the policy, or they may be made in one up-front premium. If insurance premiums are paid over the life of the policy, they may be paid according to a predetermined payment schedule (for example, level payments), or they may be adjusted periodically to reflect changing risk conditions. If payments are determined according to a predetermined schedule, the insurance policy is, in effect, a guaranteed renewal policy. Renewability imposes extra risk on the insurer because premiums cannot be adjusted for unforeseen changes in factors determining risk. Thus, insurance premiums for renewable policies are adjusted above expected premiums of nonrenewable contracts.

If Federal insurance is provided to life insurance products, this coverage could theoretically be properly priced under a variety of payment schedules. For example, premiums for increased coverage for pension benefits could be prepaid by increasing current PBGC premiums for all defined benefit pension plans over the life of the plan to reflect the cost of post-termination annuity coverage. Premiums for this increased coverage could also be prepaid by having a terminating pension plan pay a single up-front premium upon termination of the plan which would guarantee the annuities purchased to satisfy plan obligations. Of course, if current premiums are at levels higher than necessary for current coverage, extended coverage to annuities acquired by pension plans may not require greater premiums. However, given the PBGC's current accumulated deficit, this seems unlikely.

Alternatively, additional coverage for annuity and life insurance contracts could be paid over the life of the contract by the life insurance companies who issue the contract. Under this approach, no distinction would be

necessary for pension annuities over other insurance products. Insurance companies could adjust the premiums charged to policyholders to reflect the cost of a Federal guarantee program.

4. Economic consequences of inadequate pricing

Cross subsidization

In general, if insurance is inadequately priced, in order for the insurance fund to remain solvent it is necessary for some class or classes of insureds (i.e., lower risk insureds) to be overcharged and subsidize another class or classes of insureds that pay inadequate premiums (i.e., higher risk insureds). This subsidization could occur, for example, under the current PBGC premium structure if the risk-based premium does not adequately increase premiums to reflect the risk of underfunded plans.[27] Alternatively, this subsidization could occur over time if the aggregate level of current PBGC premiums were inadequate to meet future payments by the fund. Future premiums might need to be increased for losses on existing plans in order to prevent insolvency. If premiums were not increased on future plans to reflect these losses, the PBGC might not be able to meet its future obligations without direct Federal assistance.

Such subsidization encourages misallocation of resources that in turn results in economic inefficiency. For example, most sectors of the economy may maintain fully funded plans while just a few industries have substantially underfunded plans. With inadequate premiums on the riskier plans, the underfunded plans drain resources from other sectors and as a result reduce productivity and output and increase prices in the sectors of the economy with less risky plans.[28]

Moral hazard

If there is inadequate pricing of insurance, insureds do not have improper incentives for managing risk. With a flat

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[27] For example, under the current PBGC premium schedule total annual premiums are capped at $72 per participant. This amount could substantially understate the cost of insurance for underfunded plans of firms in financial distress.

[28] Underfunded plans are heavily concentrated in the transportation, transportation equipment, and primary metals industries. See Arnold J. Hoffman (1989), "Funding Levels of Private Defined-Benefit Pension Plans by Industry, The Relationship between Output, Employment, and Funding 1985: Termination Funding Ratios," in U.S. Department of Labor, Pension and Welfare Benefits Administration, Trends in Pensions, Washington, D.C., pp. 137-152.

rate premium structure, there is no incentive to reduce risk. With a premium structure inadequately adjusted for risk, companies may not adequately reduce exposure to risk. This is especially true for companies near insolvency. With little or no remaining equity, companies facing insolvency would find it advantageous to increase the riskiness of investments.

Adverse selection

If there is inadequate pricing of insurance, lower-risk plans have an incentive to leave the PBGC insurance system. For example, if PBGC insurance were not mandatory for most defined benefit pension plans, overcharged low-risk plans would not freely purchase pension benefit insurance. Since the system is mandatory for defined benefit pension plans, an employer can only leave the system by terminating its defined benefit pension plan. Thus, if insurance premiums are not adequately adjusted to reflect risk, the insurance system may actually discourage provision of pension benefits through defined benefit pension plans. To the extent low-risk insureds leave the insurance system, the average riskiness of the remaining pool of insureds increases. Increased overall risk would require further premium increases or other sources of funding. This, in turn, could drive more low-risk insureds out of the risk pool and further exacerbate the problem.

Analogy to Federal deposit insurance

The provision of Federally provided insurance coverage for insurance company products raises many policy issues similar to those raised by Federal insurance of banks and thrift institutions. As mentioned above, poorly priced insurance could result in an inadequate insurance fund, a misallocation of resources, incentives to leave the insurance system, and excessive risk taking. Federal insurance of insurance products could remove incentives for purchasers of the products to be concerned about the financial health of the insurance company issuing the contracts. Just as insured depositors often seek the highest rate of interest without regard to the financial condition of the depository, purchasers of annuity and life insurance contracts might seek the lowest price for an annuity without regard to the financial condition of the insurance company.
Like Federal deposit insurance, Federal insurance of life insurance and annuity contracts would allow financially unsound institutions to compete on an equal basis.

B. Alternatives to Federal Guarantees for Pension Benefits

Another possible approach to providing security for contracts issued by insurance companies is to impose Federal standards on the companies. Such standards could be adopted

in addition to or in lieu of a Federal guarantee.

Standards for pension annuity issuers could be imposed in a number of different ways. For example, the fiduciary standards under ERISA could be modified so that it is a violation of fiduciary duty to purchase a pension annuity from a company not meeting certain Federal standards. Such standards could also be incorporated into the PBGC plan termination procedures. Thus, for example, one of the conditions of a standard termination could be that annuities are purchased from a company meeting the Federal standards. The rules could also be incorporated into the qualification standards of the Code. A combination of these approaches might be necessary to ensure that the rules apply to purchases of annuities by ongoing plans as well as purchases on plan termination.

Federal standards for all life insurance products could take a variety of forms. For example, certain reserve requirements or limitations on the investments of insurance companies could be imposed.[29] Insurance companies from which insured contracts could be purchased could be limited to companies with a certain financial rating.

In order for Federal standards to have any affect, they would generally need to be in addition to or more strict than current State law requirements for insurance companies. If the requirements are not more strict than State law in general, then the Federal standards would be unnecessary. If the Federal rules are less strict than State law, there may be pressures on the States to lower their requirements. The standards could be coordinated with State law, however. For example, no additional Federal standards could be imposed if a State maintained a guaranty fund meeting certain requirements.

Care would need to be taken to develop appropriate standards. For example, if the standards are too strict, then few companies will meet them. This could reduce competition in the industry and unnecessarily raise the cost of annuities. Moreover, a limited number of insurance companies might not be able to absorb the risk sufficiently.

One of the major problems with this type of approach is that it may not be effective to protect the insured benefits. Although the Federal standards might be met at the time the contracts are purchased, they would not prevent the insurance company from becoming insolvent later on.

Another possible approach is to attempt to deal with

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29 Of course, such requirements could create conflicts between Federal law and State regulation.

conflict of interest problems. Conflicts of interest can arise in the termination of an overfunded defined benefit pension plan. After the benefits of plan participants are provided, the employer is generally entitled to any remaining assets.[30] Thus, the employer has an incentive to accept the lowest annuity bid, even though the company making that bid might not be the most secure. (On the other hand, a higher bid does not necessarily mean that the company is more secure.)

One approach to this type of problem is to require that an independent fiduciary select the insurer when annuity contracts are purchased on behalf of a participant in a terminating defined benefit pension plan. This approach has been followed in some cases by the DOL in granting administrative exemptions to the prohibited transaction rules. This approach would not necessarily increase pension benefit security, however, because it would not guarantee the continued solvency of the insurer.

A second approach is to eliminate the conflict of interest altogether, by removing an employer's right to remaining plan assets after a termination. Plan assets in excess of those necessary to pay promised benefits could be required to be rolled over into another qualified plan maintained by the employer, or to be distributed to participants of the terminating plan instead of the employer. Alternatively, a 100-percent reversion tax could be imposed on the remaining assets so the employer would receive nothing when a plan was terminated. This would remove the incentive for an employer to accept the lowest annuity bid. It also would remove the incentive to terminate an overfunded plan in the first place, since the employer could no longer claim the excess assets for its own use.

Private enforcement mechanisms could also be strengthened. The ability of a private party to challenge the selection of an annuity provider could be strengthened by requiring disclosure to plan participants of who the provider is, and of the selection process used to choose the provider. More generally, private suits could be encouraged by providing for the mandatory award of attorney's fees to prevailing plaintiffs in ERISA actions, and for the mandatory award of expert witness fees to prevailing plaintiffs. Participants could also be required to be given the choice of a lump-sum benefit payment or an annuity contract.

In the case of investments in insurance companies by

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[30] Such a reversion is generally permitted only if the plan provides that the employer is entitled to the excess assets and the plan provision has been in effect for at least 5 years before the reversion.

participants in defined contribution plans, additional disclosure requirements could be added to make sure that participants understand the risks involved in the investment.

Finally, some of the qualification and taxation issues surrounding the Executive Life situation could be clarified legislatively.